APPENDIX

Notes for F.O.M.C. Meeting
October 2, 1984

Sam Y. Cross

During late August the dollar firmed slightly, but then again surged higher in the period starting Labor Day. It reached new record peaks for the floating rate period against the German mark and all-time highs against most other European currencies before falling back in the past ten days in volatile trading and erratic markets.

The dollar's latest rise began at a time of reassessment, after the summer holidays, when many exchange market participants were impressed that U.S. interest rates had remained firmer than they had earlier expected. Market participants also commented increasingly on what they saw as a remarkably relaxed attitude of foreign monetary officials toward the dollar's rise. This perception was reinforced during September by comments of German central bank officials about the small impact which recent mark depreciation has had on German inflation, and about the limited usefulness of central bank intervention in the exchange markets. The strong showing of the Administration at the beginning of the Presidential campaign also contributed to positive sentiment toward the dollar, and reinforced the widespread view that the dollar is an attractive long-term investment. In addition the new Mexican debt agreement was announced, and that led to anticipation of increased dollar demand, on grounds that the agreement contained a currency conversion feature allowing the banks to shift part of Mexico's debt from dollars to foreign currency denomination, and it was assumed that such shifts would lead banks to buy dollars in order to match their books. The Desk entered the market once during this period, on September 7, selling $50 million against German marks, at a time when the dollar was rising strongly in apparent contradiction to the domestic credit markets where a decline in interest rates had already begun to emerge.

Nevertheless, the market was anxious to test the DM3.00 level and the dollar continued to rise. By September 12 it had broken through that benchmark, whereupon the advance gathered even stronger momentum. By early Friday, September 21, the dollar had risen almost 11 percent against the mark from levels of your last meeting to reach DM3.1765.

Under these circumstances, the Bundesbank had modestly increased the size of its dollar sales at the daily fixings in Frankfurt. But it had otherwise decided not to try to buck the dollar's strong upward trend until it sensed an opportunity to turn the tide, and restore a sense of two-way risk to the market. Thus, when a point of vulnerability for the dollar appeared on Friday, September 21, following publication of our consumer price index figure for August, the German Bundesbank sold $450 million aggressively and in the open market in late Frankfurt-early New York trading. Natural demand for the dollar dried up as dealers struggled in extremely chaotic markets to dispose of their own positions as well as the dollars acquired from the Bundesbank's surprise operation. By the New York close, the dollar had dropped a total of 13 pfennigs or 4 percent, from its high earlier that day. On the following Monday, the dollar dropped briefly below DM3, as the Bundesbank continued its sales and other European central banks also sold dollars, mainly to restore their cross rates vis-a-vis the German mark. Total net dollar sales by foreign central banks, which in the first 5 weeks of the intermeeting period had come to only $600 million, exceeded $1.5 billion in the last two weeks.

Meanwhile, U.S. authorities also operated after September 21, not to knock the dollar down in the manner of the Bundesbank operation, but rather to resist any pronounced upward trends of the dollar. We sold a total of $135 million at various times last week, starting early Monday morning in the Far East when the dollar/mark exchange rate was rising. These sales, like the $50 million sold earlier in September, were shared equally by the Federal Reserve and the Treasury.

Since these operations the dollar has traded generally between DM3.02 - 3.08. Sentiment towards the dollar remains positive for the same reasons as before. But the experience of the last two weeks has definitely led to a more cautious attitude toward holding long dollar positions, and the central bank operations appear to have broken at least for now the strong upward surge of the dollar. The markets remain nervous, with sharp rate movements and wide spreads.

Recommendation

Mr. Chariman, as of today the System's balances in German marks have reached a total of $3,910 million equivalent, only $90 million below our informal authorized limit of $4 billion equivalent. Since the limit was last changed in March 1983, mark balances have risen by $462 million, more than half of which represents interest earnings and the remainder from the results of intervention. I recommend that the limit should now be increased by $500 million to $4.5 billion equivalent, in order to provide room for estimated interest earnings on our mark balances of about $200 million over the next year as well as for possible intervention operations. Our holdings of other currencies are well within their limits and do not require any change. I might note that for the U.S. monetary authorities as a whole, Treasury plus Federal Reserve, our combined foreign currency balances declined in 1983 by $2.4 billion equivalent, as a result of paying off Carter bonds and using marks and yen to cover a portion of the U.S. subscription to the IMF.

Authorized balance	Maximum	Utilized	Available
		(In millions)	
Total all currencies	$5,500.0	$4,844.2	$655.8
Deutsche marks	4,000.0	3,909.7	90.3
Japanese yen	1,000.0	604.8	395.2
Other currencies	500.0	329.7	170.3

PETER D. STERNLIGHT
NOTES FOR FOMC MEETING
OCTOBER 2, 1984

Domestic Desk operations since the last meeting of the Committee were conducted against a background of weaker-than-anticipated monetary growth, suggestions of a slowing economic advance, and a strong dollar in foreign exchange markets. After starting out the period by aiming for a continuation of about the same degree of reserve pressure sought since late March--characterized by adjustment and seasonal borrowing at the discount window of around $1 billion--there was a gradual relaxation of such pressures, in line with the guidance provided in the Committee's Directive and accompanying discussion at the last meeting. Borrowing levels built into the nonborrowed reserve path were progressively trimmed, most recently to $750 million. Moreover, in meeting indicated reserve needs, the Desk tended to act fairly promptly and vigorously, several times resolving uncertainties on the side of providing more rather than less reserves. This was especially so at times when the dollar was exhibiting particular strength.

Given this approach to operations, and with the further reinforcement that market participants could observe much the same set of background factors that was guiding the Desk, reserve availability became more plentiful and the Federal funds rate declined. While this exerted a downward force on most market interest rates, there was a good deal of to-and-fro movement, and the net rate changes were moderate in most sectors.

Early in the interval, with the reserve objective still based on a $1 billion borrowing level, the Federal funds rate remained high, averaging around 11 5/8 percent. Getting into early September, funds still averaged close to 11 5/8 percent, even though the assumed borrowing level had been pared to $900 million and actual borrowing was a still more moderate $750 million. Probably, the sustained high rate level reflected a combination of inertia and real or anticipated seasonal pressures around the Labor Day period. By mid- and late September, under a fairly persistent barrage of reserve-providing moves by the Desk, though with only a slight further reduction in the assumed borrowing level to $850 million, the funds rate finally gave ground. It gradually worked below 11 1/2 percent in the week that included the September corporate tax date, and fell more noticeably to trade largely under 11 percent in the week of September 26. For the two-week period ended the 26th, funds averaged about 11 1/8 percent while actual borrowing continued to average around $750 million. So far in the current reserve period, which began last Thursday, funds have bounced around rather widely for the early part of a reserve interval, ranging from 10 to as much as 13 percent, but centering around 11 to 11 1/2, with the reserve path now built to assume borrowing of $750 million. A little surprisingly, given recent experience, several large banks have used the window early in this reserve period, as borrowing is starting this reserve period at about twice the assumed level. This may partly reflect high demand for excess reserves around the quarter end.

The market is quite thoroughly convinced by now that the System is seeking less reserve pressure than earlier, but they are uncertain about the extent of the move, or its likely implications for the funds rate, or other rates. Probably a central tendency of expectations just now would have funds likely to range around 11 percent, but market assessments remain fuzzy, as do our own.

For most of the period, the Desk was providing reserves in size, to counter the impact of increased currency in circulation, higher required reserves (including a phase-in step from the Monetary

Control Act) and higher Treasury balances. Near the start of the period, and again near the end, the System sold some few bills to foreign accounts, while yesterday we ran off bills in the weekly auction. For the full period, on a commitment basis, the System's outright securities holdings were increased by $2.2 billion, although at a point near the end of the period the net increase had been over $3.8 billion, nearly exhausting the normal $4 billion leeway. Thus, as it turned out, we did not need the enlarged leeway approved last time, though we came close. The largest operation during the period was a market purchase of $1 3/4 billion of bills on September 5. The System also bought a net of $850 million of bills and $600 million of short maturity notes from foreign accounts. Yesterday, we arranged to run off $1 billion of bills maturing this Thursday. The most recent need to absorb reserves reflects the start of a decline in Treasury balances at the Fed and renewed increases in Continental Bank's borrowings at the window. From August 30 to September 24, the Desk appeared in the market nearly every day to arrange repurchase agreements for its own account or on behalf of customers.

As noted, while a number of market interest rates declined over the interval there was considerable backing and filling that produced only moderate net declines for the most part. Longer term maturities were subject to particularly diverse influences responding at times to the signs of slower money growth, slower economic expansion, and a sense that the Desk was being more accommodative, but taking sober note at other times of the possibility that the economy could re-accellerate and inflation could push higher. While the Treasury market was called on to take up a relatively moderate $7 1/2 billion in new money through coupon issues--an amount held down somewhat by debt ceiling delays--dealers are well aware of the prospective mountain of coupon issues to be taken down starting in the next few days, presumably as soon as the debt legislation passes, up through the first several days of November. That figure could exceed $40 billion, more than half of it new money. Against this background, intermediate and longer term Treasury yields--say from four years on out--have come down only a modest 5 to 20 basis points.

There is particular uncertainty about the next batch of Treasury coupon debt as it may include a 20-year bond callable in 5 years. The market is not sure how to evaluate this feature and it is being regarded with notable lack of enthusiasm. There are also mixed reviews for a prospective 4 year note to be targeted to foreign buyers and offering a measure of anonymity to its holders.

Rate declines were somewhat more pronounced among shorter maturities, where the lower funds rate and related financing costs had a greater influence. Shorter coupon issues, 1 or 2 years, came down about 30-35 basis points while key bill yields were down about 20-30 basis points. The Treasury raised about $5 billion in the bill market. Three- and six-month bills were auctioned yesterday at about 10.23 and 10.35 percent, down from 10.40 and 10.59 percent just before the last meeting.

Among private credit instruments, the short-term area saw greater declines than for Treasury bills--with commercial paper and bank CD rates down about 50 basis points. In turn, this paved the way for a 1/4 percentage point cut in the bank prime rate to 12 3/4 percent. As CD rates declined more than bills, their rate spread narrowed, providing some further indication of lessened anxiety about quality differentials.

Corporate bond rates declined about in line with intermediate and longer Treasury yields, with domestic issuance on the moderate side and relatively greater activity reported in the Eurobond area--thus perhaps adding to the dollar's strength. Finally, as distinct from other segments of the market, tax-exempt rates moved a little higher over the period, as sizable new supplies were digested with some difficulty.

JLKichline
October 2, 1984

FOMC BRIEFING

The pace of economic activity slowed considerably during the summer and the staff is forecasting growth of real GNP in the third quarter at a little under 3 percent annual rate. This is a weaker performance than we were expecting at the time of the last meeting of the Committee, and is associated with sluggish growth of final sales. In assessing recent and prospective developments, the staff believes the economy is undergoing an adjustment to more moderate rates of growth than experienced earlier in the expansion and that the recent slowdown is not a forerunner of stagnating or declining activity in coming quarters. Thus, we have not altered significantly the projection through 1985 which points to real growth around a 3 percent annual rate and moderate wage and price inflation.

Consumer spending during July and August was notably weak. The advance report on total retail sales in August pointed to a further decline after the steep drop in July; those declines were broadly based among both durable and nondurable goods. For September there are a few scattered reports of a pickup in consumer spending and, in the only area where we have hard data, the auto market, sales were up appreciably during the first 20 days.

The forecast in fact incorporates a bounceback in spending for September and for the fourth quarter as well. Such a rise in spending seems the best bet at the moment given that consumer attitudes and balance sheets appear to be in good shape and we often have temporary lulls in spending following a surge. In addition, incomes are continuing to expand, although at a reduced pace from that registered earlier in the year as employment growth has been slowing. Over the longer run the forecast contains moderate growth of consumer spending about in line with expansion of disposable income.

In the housing sector, starts fell in both July and August, especially for single-family units. The level of starts in August, however, seems a bit low relative to the underlying developments in the market, and we wouldn't be surprised to see some uptick in starts in the near term. New house sales stabilized in June and July after falling sharply in the spring. Moreover, mortgage credit costs have been trending lower since July and there are still reports of initial discounts available on adjustable rate mortgages. While these developments should be supportive in the short run, the housing sector, however, is likely to be constrained by the level of mortgage rates and the forecast for 1985 entails a small decline in residential construction expenditures in real terms.

Expenditures for business fixed investment grew less rapidly during the third quarter than the exceptional pace over the preceding year. The slowdown, however, was more marked than we had been anticipating and raises some questions about the behavior of investment. Orders for nondefense capital goods have declined for three consecutive months and shipments for two months, and data on construction put-in-place are running lower than expected. In part, the domestic shipments and orders information understates investment in equipment because of the continuing rapid growth in imports of capital goods. And there remain strong elements in the picture including large backlogs of unfilled orders, good profits and the higher levels of capacity utilization in place. Even with the forecast of slowing final sales,we had thought investment would provide strength to activity and that still seems likely. The recent data, and some fragmentary information on McGraw-Hill's fall survey of 1985 spending plans, however do raise a caution sign.

Inventory investment was quite large in July, the last monthly reading, and is expected to add considerably to real GNP growth for the quarter as a whole. Inventory growth probably was bolstered by both the surge in imports and by slowing of domestic demands relative to production. In general there do not appear to be significant overhangs in the aggregate, although there have been downward production adjustments to match orders in some consumer goods, building materials, and metals, for example. Industrial output in August rose only 1/4 percent and aside from the effects of the auto strike, a similar small gain would seem likely for September. Thus we expect the higher growth in final sales and lower rates of domestic production to be sufficient to avoid undesired inventory accumulation.

The changes to real growth over the forecast period have resulted in a little lower level of activity than we had projected in August and slightly more slack in labor resources. The combination of a somewhat higher unemployment rate, continuing moderate wage performance, and a higher foreign exchange value of the dollar on average, has led us to take a few tenths off the projected wage and price inflation over the forecast. The GNP implicit deflator is expected to increase about 4 percent in 1984 and 4-1/2 percent next year.

FOMC Briefing
October 2, 1984
S. H. Axilrod

Since the last Committee meeting, financial markets have been quite volatile. In domestic long-term credit markets, bond prices and interest rates have fluctuated widely on a day-to-day basis, with rates on balance over the period down a little. In foreign exchange markets, the value of the dollar has fluctuated widely around what turned out to be a surprisingly strong rising trend. Meanwhile, bank reserve positions were easing, as the aggregates and the economy weakened, and the federal funds rate dropped from the 11-1/2 to 11-3/4 percent area to around 11 percent, with trading at times in late September in the 10-1/2 to 11 percent range.

The volatility in the bond market and the failure of long-term rates to drop further or more consistently was, in my view, fundamentally embedded in unresolved questions about the underlying strength of credit demands. Large fiscal deficits still overhang the market. Moreover, participants at this time seem to view the recent slowdown in real economic growth not as a harbinger of sharp further weakening but more as an inflexion point. If it presaged substantial weakness, it would more clearly from a market perspective point to a downward trend of interest rates, but as an inflexion point, it still leaves open questions about whether private credit demands will slow enough to take pressures off interest rates given the budgetary deficits still thought to be in prospect.

Longer-term market rates have in fact dropped some 1-1/2 percentage points and primary mortgage rates about 50 to 75 basis points since around mid-year, but the great bulk of the decline occurred before the previous FOMC meeting. Without the recent drop in the funds rate, which brings it back to about its mid-year level, it is quite possible that long-term rates would have backed up over the past several weeks, given the uncertainties about how much easing can in practice be expected in credit demands. In that context, the large volume of Treasury note and bond offerings in prospect over the next few weeks--some of which have been postponed because of the delay in debt ceiling legislation--will provide a real test of the capacity of, and attitudes in, the long-term market.

Domestic credit markets have also been faced with what must seem to be a puzzling rise in the dollar, given the state of the U.S. current account. Many people expect that when domestic interest rates go down, for given foreign interest rates, the dollar will also drop on exchange markets. In that sense, the rising dollar tended to provide signals to the domestic credit market contrary to those provided by declining money market interest rates. It seemed to suggest a somewhat different assessment of the future, one more consistent with a sense that interest rates will remain high enough to keep the dolar quite valuable relative to other currencies on exchange markets.

The relatively high dollar can be viewed from another perspective. It may be taken as signaling a monetary policy that has become excessively taut in the face of, say, gathering confidence here and abroad that the rate of inflation is coming under good control. One would need to argue in that case that the current level of nominal market interest rates provides a real return that is overly attractive to investors relative to what can be earned over time by private borrowers on capital investments, and that both interest rates and the exchange rate should and would at some point both decline. Domestic bond markets are clearly not convinced of such an analysis, at least yet, since yields have not behaved as if a serious weakening of the economy were in prospect.

One could take the position that the recent fairly marked slowing in expansion of housing and of indicators of plant and equipment spending suggests that long-term rates are in real terms higher than is sustainable--that is, are higher than the expected real rate of return on physical investment. That would, in my estimation, probably come to be the prevailing view in markets except for doubts about whether the fiscal stimulus may not be so strong as to lead to an unusually high level of real rates under present circumstances; or if it were not for doubts that real rates might yet decline through the medium of greater price increases rather than nominal rate declines.

Choices among the monetary strategies before the Committee--which all involve growth in money measures over the year as a whole within or very near to the longer-run ranges--may depend in part on assessment of the significance for real spending and inflation of the present interest rate structure. Alternative A--which involves a further downward thrust to nominal rates--may seem more appropriate if there is a conviction that the present nominal interest rate structure is higher than needed to curb inflationary tendencies, that their real impact is not likely to be weakened by accelerated price increases. On the other hand, if there is a conviction that, for instance, the latest CPI figure presages more intense upward pressures on prices, one might argue for a return to the market conditions prevailing at the time of the previous FOMC meeting, as embodied in alternative C. Alternative B obviously assumes a more neutral stance at this time.

I might add that in the blue book alternative B suggests retaining the present funds rate range of 8 to 12 percent, even, though the initial level of borrowing is assumed to be the current $750 million rather than the

$1 billion initial level implicit at the time of the last meeting. One argument for retaining the 8 to 12 percent range is simply to provide some headroom, given the recent variability in the borrowing-funds rate relationship. A reduction in the upper limit to 11-1/2 percent would need to be considered if the Committee intended to avoid, at least before further consultation, any very significant reversal of the recent rate declines with an associated change in over-all market conditions.